

Department of Treasury Position Memo

To: Treasurer Nick Khouri
From: Ken Osborne (TREASURY)
CC: Greg Gursky, Paul Connors
Date: September 24, 2018
Re: Senate Bill 1097

Treasury Position: Opposed

Short Summary: Senate Bill 1097 would exclude interest deduction limitations under Section 163j of the Internal Revenue Code from the calculation of "Federal Taxable Income," which is the tax base for Michigan's Corporate Income Tax. Specifically, the TCJA generally limits the deduction for interest expenses to 30 percent of the sum of its taxable income and its business interest income.

Background: Last year Congress passed, and the President signed the Tax Cuts and Jobs Act, which enacted broad tax reform at the federal level. As it applies to businesses these reforms reduced the tax rate to 21% while expanding the tax base by eliminating or changing credits and deductions. Because Federal Taxable Income serves as the base for Michigan's Corporate Income Tax, these changes also had an impact on the tax liability for some firms under the CIT. Some provisions will result in increased state liability, while others will result in decreased liability. In the aggregate it was assumed that state revenue from "business" taxpayers will increase relative to 2017 due to the TCJA. The interest deduction is the largest change which results in increased tax revenue for the state.

The broad impact of federal tax reform was discussed in the attached document. It should be noted that the Legislature and Governor addressed the impact on individual income taxpayers and provided tax relief to individual taxpayers that roughly offset the net impact on Michigan revenues related to federal tax reform.

Discussion of Key Principles:

Efficiency: The bill does not impact the tax from an efficiency perspective.

Fairness: The bill would tend to benefit firms with more debt than those with less. However, any firm could choose to structure their operations in this way. The bill does not seem to impact the tax from a fairness perspective.

Simplicity: The bill marginally complicates the tax by creating an additional mechanism by which the base of the tax for CIT purposes is different than Federal Taxable Income.

Diversification (Tax Base): The bill reduces the base of the tax relative to current law significantly by allowing firms to deduct all their interest expenses for state tax purposes. This results in a substantial reduction in revenue. See attached fiscal analysis.

Conclusion: While the TCJA impacted state revenues in a variety of ways, that impact was generally understood at the time to have broadened the tax base. Revenues associated with federal tax reform, as well as the tax cut provided for in SB 748 in response to federal tax reform have been incorporated into the budget enacted for the upcoming fiscal year.

Department of Treasury opposes the bill.

TREASURY FISCAL IMPACT ANALYSIS

<u>BILL NUMBER/SUBSTITUTE:</u>	SB 1097 (pending introduction)																																										
<u>DATE OF ANALYSIS:</u>	September 4, 2018																																										
<u>TAX:</u>	Corporate income tax																																										
<u>DESCRIPTION OF BILL:</u>	The bill decouples the corporate income tax from IRC section 163(j). The most significant impact on revenue would result from not applying the limitation on deductible interest expense that was added with federal tax reform.																																										
<u>PROBLEMS/ISSUES:</u>	Tax Policy will discuss these.																																										
<u>FISCAL IMPACT (millions):</u>	<table><tr><td></td><th colspan="4">State Gov't Revenue Impact</th><th>Local Gov't</th><th>SAF</th></tr><tr><td></td><th><u>Total</u></th><th><u>GF/GP</u></th><th><u>SAF</u></th><th><u>Other</u></th><th><u>Rev Impact</u></th><th><u>Spending</u></th></tr><tr><td>FY 18</td><td>(\$14.0)</td><td>(\$14.0)</td><td></td><td></td><td></td><td></td></tr><tr><td>FY 19</td><td>(\$115.0)</td><td>(\$115.0)</td><td></td><td></td><td></td><td></td></tr><tr><td>FY 20</td><td>(\$97.0)</td><td>(\$97.0)</td><td></td><td></td><td></td><td></td></tr><tr><td>FY 21</td><td>(\$97.0)</td><td>(\$97.0)</td><td></td><td></td><td></td><td></td></tr></table>		State Gov't Revenue Impact				Local Gov't	SAF		<u>Total</u>	<u>GF/GP</u>	<u>SAF</u>	<u>Other</u>	<u>Rev Impact</u>	<u>Spending</u>	FY 18	(\$14.0)	(\$14.0)					FY 19	(\$115.0)	(\$115.0)					FY 20	(\$97.0)	(\$97.0)					FY 21	(\$97.0)	(\$97.0)				
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<u>DATA USED FOR ANALYSIS:</u>	Federal estimates prepared by the Joint Committee on Taxation were apportioned to Michigan and then adjusted to account for Michigan's tax rate.																																										
<u>OTHER COMMENTS:</u>	The federal provision applies to all businesses, although approximately 95% of the impact is estimated to apply to corporations. This amendment to section 607 of the Income Tax Act would only affect corporations taxable in Michigan. The revenue impact is shifting from FY 2018 to FY 2019 to reflect payment timing. The combined impact for fiscal years 2018 and 2019 is the same.																																										
<u>ANALYSIS BY:</u>	Scott Darragh																																										

Prepared By: Office of Revenue and Tax Analysis, Michigan Department of Treasury

Filename: V:\ORTA\LEGISLATIVE\2018\BillsAnalyzed\SB1097_DecoupleInterestExpenseDeduction.xlsx\Sheet1

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Impact from the Tax Cuts and Jobs Act

- The Tax Cuts and Jobs Act will have a direct impact on Michigan taxes, as both individual and corporate income taxes rely on federal income measures as a starting point of the Michigan return. Additionally, many of Michigan's tax definitions are tied to the federal Internal Revenue Code.
- Treasury has estimated the impacts of reforms that directly impact Michigan taxpayers. A table summarizing the estimated impact to Michigan taxpayers is below.

Michigan Revenue Impact from the Tax Cuts and Jobs Act (millions of dollars)

	FY 2018	FY 2019	FY 2020
Impact from the Personal Exemption	\$840	\$1,647	\$1,482
Other individual income tax impacts	-\$14	\$10	\$44
Corporate income tax impacts	\$22	\$70	\$103
Total	\$848	\$1,727	\$1,629

- The biggest change results from the personal exemption, which was set to zero in the tax reform. Michigan's exemption is set to the number "allowable on the taxpayer's federal income tax return" (MCL 206.30(2)). The act therefore eliminates the ability for Michigan taxpayers to claim the exemption.
- The elimination of the personal exemption accounts for 97 percent of the total fiscal impact in FY 2018, 95 percent in FY 2019, and 91 percent in FY 2020.
- Other changes from the legislation are much smaller than the change from the exemption. Changes from the Tax Cuts and Jobs Act on expensing, bonus depreciation, and simplified accounting will decrease Michigan taxes on individuals and corporations. Provisions on pass-through losses, net operating deductions, expense deductions will increase revenue.
- Typically, all revenue forecasts estimate current law provisions. Due to the timing and potential action taken by the legislature to change these impacts, the amounts are not included in the Administration or Consensus Conference revenue estimates. All of these provisions, and any enacted legislative response, will be included in the May 2018 consensus revenue forecast.